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Summary of the *Economic and Social Survey of Asia and the Pacific 2016*

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith a summary of the *Economic and Social Survey of Asia and the Pacific 2016*.

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Summary of the *Economic and Social Survey of Asia and the Pacific 2016*

[Original: Chinese, English, French and Russian]

Summary

The pace of economic expansion in Asia and the Pacific has decelerated considerably in recent years and, clouded by uncertainty, is expected to plateau at around 5 per cent for 2016 and 2017. Although sluggish exports contributed significantly, this slowdown also reflects moderating domestic demand. A confluence of downside risks may threaten even this relatively moderate pace of growth. Key risks discussed in the *Economic and Social Survey of Asia and the Pacific 2016* are: a somewhat uncertain outlook for the Chinese economy against the backdrop of fragile global economic recovery; volatility in exchange rates, partly due to low oil prices for commodity exporters; growing private household and corporate debt; and an ambiguous path of interest rate increases to be pursued by the United States of America.

Taking advantage of low inflation, many economies have lowered interest rates to support growth. However, the Survey argues that further loosening will be difficult because of capital outflow and financial stability considerations. While many Governments have sufficient fiscal space to scale up development expenditures in areas such as education, health and infrastructure, they also need to expand their tax bases, particularly as stronger fiscal positions will be required to cope with the consequences of economic slowdown for poverty, inequality and employment prospects.

The *Survey* also highlights that multifaceted challenges arising as a result of the rising middle class and rapid urbanization in the Asia-Pacific region will test the capacities of Governments to revive economic growth and pursue sustainable development.

To bolster Asia-Pacific economic growth and effectively pursue the 2030 Agenda for Sustainable Development, the Survey makes the important point that the Governments will need to give higher priority to domestic and regional demand. Raising domestic demand will require higher levels of productivity and commensurate increases in real wages. Strengthening productivity will also contribute to the success of a number of the Sustainable Development Goals. At the same time, investing in achievement of the Sustainable Development Goals will also nurture productivity growth, creating a virtuous cycle between sustainable development, productivity and economic growth.

Emphasizing the need for higher labour productivity in agriculture, the *Survey* underscores the importance of industrialization, especially in rural areas. It cautions developing economies in terms of their rapid transformation towards the services sector and leapfrogging of manufacturing and contains numerous proposals to increase productivity, including an emphasis on the importance of high-quality education to promote innovation and enhance skills.

I. Introduction

1. Inclusive and sustainable economic growth is essential for the success of the 2030 Agenda for Sustainable Development. Robust and consistent economic performance is also necessary to implement the Addis Ababa Action Agenda of the Third International Conference on Financing for Development and the Paris Agreement under the United Nations Framework Convention on Climate Change. The pace of economic expansion in Asia and the Pacific has, however, decelerated considerably in recent years. Therefore, reviving economic growth is vital to implement these three transformative and universal new global agreements.

2. The *Economic and Social Survey of Asia and the Pacific 2016* highlights the importance of increasing productivity to reinvigorate economic growth and support sustainable development. It provides a detailed analysis of factors that have caused the recent economic and productivity slowdown in the Asia-Pacific region, and examines their implications for poverty, inequality and employment prospects. The key macroeconomic risks include: a somewhat uncertain outlook for the Chinese economy against the backdrop of fragile global economic recovery; volatility in exchange rates, partly due to low oil prices for commodity exporters; growing private household and corporate debt; and an ambiguous path of interest rate increases to be pursued by the United States of America.

3. The *Survey* also explores the issues of the rising middle class and rapid urbanization as examples of multifaceted challenges to sustainable development, and to illustrate opportunities to revive economic growth led by domestic demand. To reflect the diversity of the Asia-Pacific region, it provides a disaggregated analysis of economic issues and challenges that each of the five subregions is facing, thereby providing an opportunity to learn from a variety of experiences and policy considerations. This includes challenges relating to population ageing and pension financing in East and North-East Asia, economic diversification and development of the services sector in North and Central Asia, natural disasters and risk-sharing mechanisms in the Pacific, female labour-force participation in South and South-West Asia, and tax policy and administration reforms in South-East Asia.

4. To bolster Asia-Pacific economic growth in light of the fragile global economic conditions, the *Survey* argues that higher priority be given to stimulating domestic and regional demand, and that raising domestic demand will require higher levels of productivity and commensurate increases in real wages. While strengthening productivity will contribute to the success of a number of the Sustainable Development Goals, investing in achievement of the Goals will also nurture productivity growth, creating a virtuous cycle between sustainable development, productivity and economic growth.

II. Implications of recent economic slowdown and outlook

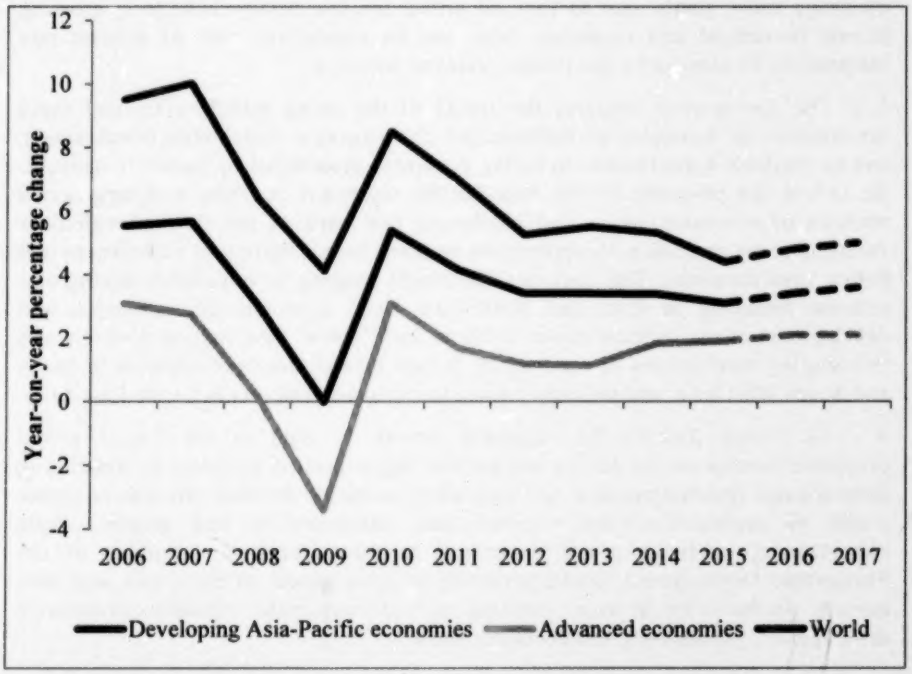
A. Economic growth dynamics

5. The economic growth outlook for the developing economies of the region is broadly stable but is clouded with uncertainty. Against an estimated increase of 4.6 per cent in 2015, economic growth in 2016 and 2017 is forecast to increase marginally to 4.8 per cent and 5 per cent respectively. The reason for the lack of

significant uptick in growth forecast is the expected continuation of a number of factors buffeting the region. Important among them are: the fragile global economic recovery in most developed economies; a continued slowdown in the Chinese economy; weak consumption and investment trends in major Asia-Pacific economies; and declining trends in labour and total factor productivity.

6. Given the export-led growth orientation of many developing economies of the Asia-Pacific region, the fragile recovery in the advanced economies is an important factor holding back faster economic growth (see figure I). With the outlook for the European Union and Japan continuing to remain weak, alongside a somewhat better expected growth performance in the United States of America, prospects of an export-led recovery in developing Asia-Pacific economies will broadly remain subdued. Particularly affected would be the manufacturing export-dependent economies of East and North-East Asia and South-East Asia.

Figure I
Growth in developing Asia-Pacific economies and major global developed economies, 2006-2017



Source: ESCAP forecasts and International Monetary Fund, World Economic Outlook Databases. Available from www.imf.org/external/data.htm.

Note: Developing Asia and the Pacific group comprises of economies of the ESCAP region excluding Australia, Japan and New Zealand. Advanced economies group includes the European Union, the United States as well as Australia, Japan and New Zealand.

7. The slowing of the Chinese economy is the other major external challenge for exporting economies of the region. Given the large weight of China in the gross domestic product (GDP) of the developing Asia-Pacific region — 40 per cent of the total — even a small change in its GDP growth has a considerable impact on the

region's growth. The slowdown in China has been partly driven by a much-needed rebalancing to sustain growth in the medium term, away from investment and net exports towards consumption, as well as away from manufacturing and towards services. It is expected that the Government will maintain its policy focus on rebalancing in coming years, provided the growth slowdown remains gradual. This implies that monetary policy as well as fiscal policy will remain relatively restricted with regard to supporting investment.

8. The developments in China are having manifold impacts on growth prospects of other developing economies in the region. One direct impact is on the real sector through trade linkages with China. A slowdown in economic growth in China results in lower demand for intermediate products for processing and onward export from China as well as for products that help meet final demand in China. A second impact on trade comes from weakening of the Chinese currency. This affects exports by the region's economies to main trading partners because of greater currency competition. Moreover, depreciation of the Chinese currency puts pressure on other currencies in the region to depreciate as well. A decline in the Chinese currency, however, is not the only spur to currency competition. Depreciation of the Japanese currency, given its large export sector, has also played a role in recent exchange-rate depreciations observed in the region.

9. Taken together, the slowdown in China and weak global economic growth have had a particularly strong impact on commodity-dependent economies. Global commodity prices have declined to levels last seen at the time of the global financial and economic crisis of 2008, with the most dramatic reductions in the case of oil. Although global demand and supply factors have played an important role in explaining these declines, the new and most pressing driver in the past year has been concern over the prospects of the Chinese economy. The major commodity-dependent subregion in Asia-Pacific, which has been particularly hit by the slowdown in commodities demand, is North and Central Asia, while Indonesia, Malaysia and Mongolia are the major economies from other subregions that are being negatively affected. Economies where commodities play a major role in exports have seen the greatest declines in their GDP growth between 2014 and 2015.

10. Given the weaknesses emanating from external conditions, domestic demand is likely to play a major role in supporting growth in most developing economies of the region. Some support for growth in domestic demand is likely to come from expected progress in reform policies of major developing economies of the region. These measures include simplification of regulatory structures and government infrastructure programs. However, the role of domestic demand is also expected to remain relatively constrained in the baseline scenario. For instance, growth in domestic consumption and investment in some economies is likely to be negatively affected by the relatively high levels of household and corporate debt that have been accumulating at a rapid pace over recent years. Going forward, a larger share of household incomes and corporate earnings will be directed towards debt payments, constraining further impetus to demand. Investment will also continue to be affected by the general uncertainty regarding prospects for the global economy, with investors remaining wary of undertaking long-term decisions, as well as by excess capacity and low utilization rates in some cases.

11. Low interest rates, ample liquidity and increased access to cross-border loans and international capital markets are the main drivers of sharp increases in household and corporate debt. In the wake of the global financial and economic crisis of 2008, debt finance played an important role in sustaining the region's high economic growth. While some of this was desirable, reflecting the region's financial development, events in the past year, such as the depreciation of the Chinese currency and increase in interest rates in the United States of America, have exposed the risks associated with higher debt, in terms of both financial stability and future growth prospects.

12. In order to ensure sustained growth and financial stability, Governments will need to introduce a host of comprehensive measures to address this issue of sharply growing private debt. Policy priorities should include better monitoring of household and corporate liabilities and assets, and effective use of macroprudential and capital-flow management tools. Policymakers could also increase attention to banks' sectoral exposures in addition to overall capital adequacy, while accounting for contingent liabilities on the fiscal side. However, abrupt tightening measures may further constrain the private sector's debt-servicing capacities and increase debt risks across the board. A phased yet comprehensive approach is thus recommended. At the same time, the region's financial development should continue through greater cooperation and integration.

B. Inflation and monetary policy

13. Against this backdrop, inflation in developing Asia-Pacific economies is projected to soften further to 3.7 per cent in 2016, compared to a multi-decade low of 4.1 per cent in 2015. The plunge in global commodity prices, especially of crude oil, mainly account for this decrease. While inflation is low in the region as a whole, there is considerable divergence between subregions and economies, with commodity dependence being an important driver. For instance, in economies with sizeable commodity exports, subdued commodity prices weakened the terms of trade and external account performance, which resulted in significant currency depreciations and higher inflation rates.

14. All things being equal, an overall low-growth, low-inflation environment in the region would suggest that there is further room for an easy monetary policy stance. Indeed, many economies have continued lowering policy interest rates, though this has not really lifted economic growth so far. However, in many economies, considerations relating to financial stability, in the context of high levels of private debt, will influence the conduct of monetary policy. A monetary policy stance that is kept too loose for too long could undermine domestic financial stability because firms and individuals tend to undertake riskier investment decisions, while their balance sheets look stronger than otherwise. The need to strike a balance between the role of monetary policy in supporting economic growth and ensuring financial stability is especially relevant in economies where household and/or corporate debt levels are already relatively high or rising rapidly.

15. In this context, it is worth highlighting the risk emanating from gradual yet expected increases in interest rate in the United States of America. These will put pressure on capital to flow out of the region and, as a consequence, could lead to higher interest rates in the region. The prospect of increase in domestic financing

costs does not bode well for domestic demand growth, especially fixed investment. Yet, if economies choose to maintain interest rates, they may experience higher exchange-rate pressures. It is this tension in policy consideration that is increasing uncertainty, the ultimate detriment to investment.

C. Employment, poverty and inequality

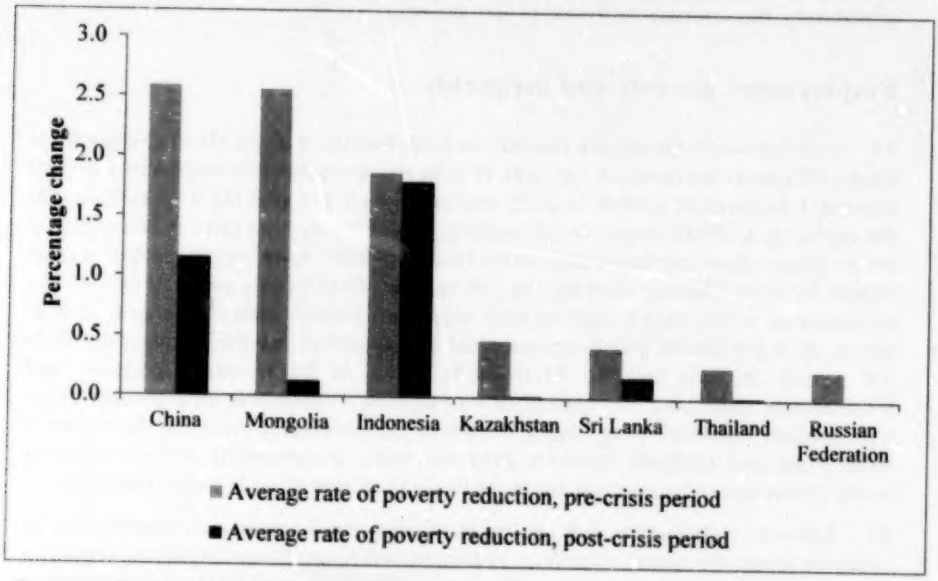
16. Even as economic growth plateaus in Asia-Pacific, it is not clear whether it has been sufficiently inclusive. A key area of concern is the quantity and quality of jobs created. Employment growth in 2015 was merely 1.1 per cent (or 21.3 million) for the region as a whole. A key factor shaping weak employment rates in the region is lower labour-force participation, partly resulting from more young people staying longer in school before entering the job market. Despite this positive part of the explanation, young people who do seek work face considerable challenges, such as taking up a job that is poorly remunerated and underutilizes their potential. While job growth in Asia and the Pacific was muted in 2015, mixed progress was witnessed in enhancing the quality of employment. Vulnerable employment as an own-account or contributing family worker in the developing Asia-Pacific region is widespread and typically involves informal work arrangements without legal or social protection. Also, women are more likely than men to be in vulnerable jobs.

17. Economic slowdown and challenges facing employment are contributing to concerns about the extent of poverty reduction and rising inequality in the region in recent years. Inclusive growth requires not only robust economic growth but also economic expansion that reaches the poorer sections of the population and assuages inequality. Available data indicates that some major developing economies in the region, accounting for a large proportion of the population in Asia and the Pacific, have seen a decelerating trend in the rate of poverty reduction in the post-crisis period as compared to the recent pre-crisis period (see figure II). Similarly, indicators of income inequality, whether gauged through Gini coefficients or the Palma index, seem to have worsened in recent years.

18. Apart from the direct impact of decelerating growth, an important driver of slowing poverty reduction and rising inequality in the post-crisis period is the underlying nature of the growth model itself, which essentially favours unfettered consumption-led debt-fuelled increases in economic output. There is nothing inherently wrong with consumption-led economic expansion. The problem emerges when a large segment of the population, especially the lower income groups, increasingly and excessively rely on debt rather than wages to support increases in consumption. This may be as a result of the outpacing of wage growth by productivity increases that many developing economies of the region have seen in recent years, and that has led to a shift in the balance between labour and capital shares in national income, resulting in unequal distribution of incomes favouring the latter.

Figure II

Average rate of reduction of the poverty headcount ratio at $1.90 a day in selected Asia-Pacific economies, pre-crisis and post-crisis periods



Source: ESCAP, based on World Development Indicators.

Notes: China 1999-2008 and 2008-2010; Indonesia 1999-2008 and 2008-2010; Kazakhstan 1996-2008 and 2008-2013; Mongolia 1998-2007 and 2010-2012; Russian Federation 2000-2008 and 2008-2012; Sri Lanka 1995-2006 and 2009-2012; Thailand 2000-2008 and 2008-2012.

19. Thus, ensuring consistent increases in wages is important for reducing poverty and inequality as the poor are more often employed in wage-earning sectors, as compared to the more well-off who rely more on non-wage income sources. A productivity-driven wage-led approach to economic growth is therefore preferable, as it has a higher chance of addressing issues of poverty and inequality, in addition to supporting sustained increases in economic growth. Moreover, slow progress in reducing poverty as well as growing inequality has further underscored the pressing need for greater social protection in the region. Apart from the need to ensure inclusive and sustainable development, greater social protection will also support regional economies in boosting the role of domestic demand in growth by reducing precautionary savings for emergencies, especially by the poor.

D. Fiscal policy

20. Countercyclical fiscal policy, unlike monetary policy, can potentially play a more supportive role for growth. Indeed, the stance of fiscal policy in the region in 2015 was largely countercyclical and expansionary. Whether fiscal policy aims to stabilize the economy or support national development, an important consideration has to do with fiscal sustainability. By and large, most developing countries in the region have relatively low levels of government debt. Moreover, recognizing that there is no mechanical or universally accepted threshold for limiting public debt,

and that fiscal austerity measures informed by the notion of a unified threshold prompted sharp output declines in Europe, the policy relevance of holding onto a particular threshold has been questioned. Ultimately, each country needs to assess the costs and benefits of higher public debt; for instance, smaller margins to cope with contingent risks against faster achievement of development goals.

21. An important consideration beyond stabilization is the potential impact of fiscal policy on the distribution of income and opportunities and on long-term economic growth. Spending on education, health and infrastructure are particularly important in this regard, and countries are trying to scale up such spending, including through debt financing or sales of certain state assets, as well as the reallocation of expenditures and improved revenue collection. However, aside from financing, it is important to improve project selection and management and implementation capacities across the board.

E. Rising middle class and urbanization

22. Despite the slowdown of recent years, faster growth in the previous decades has resulted in a noticeable increase in the middle class in many countries of the region. This has created both specific opportunities and numerous challenges. On the positive side, the middle class offers an increasing pool of domestic demand to be tapped by economies, thus reducing their dependence on the struggling external sector. A rising middle class, with higher disposable income, tends, however, to demand public services that go beyond basic needs, such as access to better quality education, health, water and recreational services along with reliable energy and information and communications technology infrastructure. This puts pressure on Governments to provide these services and, in case of expectation gaps, can lead to social tensions.

23. Managing changing consumption and production patterns and air pollution and congestion related to increasing vehicle use are other examples of challenges associated with a growing middle class. It is worth noting that in societies with high income inequality, the group earning just above $2 a day is still at the bottom of the income distribution and remains very vulnerable to falling back into poverty because of external shocks such as a persistent decline in economic growth, weaker employment prospects and natural calamities. They are considered a "transitional class" and require consistent support to strengthen their resilience. Governments will therefore need to ensure that social protection is provided for this group in particular in order to cement their position in the middle-class category.

24. A particular feature of the rise of the middle class, and the wider economic growth process in the region, is the phenomenon of rapid urbanization. This process has led to a large movement of the poor to cities and a rapid increase of the middle class in cities. Despite the positive contribution of cities to growth, not all urban dwellers have benefited from this transformation. In many cities, the majority of the urban population continues to rely on the informal sector for employment, housing and access to land, basic services such as safe water supply and transport facilities.

25. Dealing with these challenges and changing dynamics requires specific government policies. One approach is to redirect urbanization to emerging smaller cities and simultaneously enhance rural-urban linkages to move towards more balanced urbanization. Another part of the solution is to take action within existing

cities to reorient consumption patterns, develop the necessary infrastructure and improve social support structures. An important aspect of undertaking such proactive policies will be tackling the issue of insufficient local government funding. Moreover, many of the region's cities are managed with outdated legal and regulatory frameworks and institutional arrangements.

26. Rapid urbanization in Asia and the Pacific region has also significantly raised its exposure to natural hazards by exacerbating existing risks and creating new ones. Many cities in the region are outgrowing their capacity of basic service delivery, and thus exposing city dwellers, particularly those in slum areas, to disaster risk. Climate change and projected sea level rise pose further challenges, especially to coastal cities in which more than half of the region's urban population currently live. Many urban areas in the region are highly vulnerable to disaster since their comparative advantages and economic competitiveness has led to a great concentration of economic and other assets.

III. Perspectives from subregions and their policy challenges

27. In East and North-East Asia, economic slowdown in China and the Republic of Korea together with Japan's weak growth path and stubborn deflationary pressure depressed the subregion's economic expansion in 2015. The near-term economic prospects for this export-oriented subregion are not bright either, as global trade is set to expand only sluggishly in coming years. The Republic of Korea is the only economy in the subregion where growth is set to trend up steadily over 2016 and 2017 amid revived domestic demand. Key uncertainties are whether medium-term growth in China will settle around 6.5 per cent and whether the Japanese economy will return to a recession if consumption tax increases in 2017, as planned. The upside is that in most economies of the subregion there is adequate room for fiscal and monetary policy support.

28. Slower economic growth in China is partly policy-induced. This transition is indeed positive as long as progress that has been made on social development is not reversed. A more challenging situation could arise in neighbouring countries such as Mongolia, which has relied on demand from China for minerals to fuel its economic expansion in the past years. As macroeconomic policy space to cope with slowdown in China is limited, slower growth in Mongolia is perhaps inevitable and could hold back the pace of poverty reduction. More broadly, decelerating growth in China has recently been accompanied by growing concerns and heightened economic uncertainty, as reflected in global stock market sell-offs in mid-2015 and again in early 2016. An immediate challenge is how to manage the transition in China without causing too many negative spillovers to the global economy.

29. Given that economic deceleration in China is already in its sixth year, subregional economies have been seeking to increase the role of domestic demand in driving future economic growth. Despite some concrete policy efforts and examples of success, the adjustment has not been sufficiently rapid. This is largely because the transition is constrained by structural factors that evolve only slowly, such as a shrinking population in Japan, high retention of corporate and personal savings in China and relative neglect of non-export activities in the Republic of Korea.

30. The issue of ageing population poses a serious threat to the economic and social development of the subregion. The size of the working-age population in all major subregional economies is projected to fall after 2020 to the extent that elderly people could account for up to one third of the total population by 2035. The impact of rapid population ageing on fiscal sustainability could be substantial as it pushes up public spending on old-age pension schemes and health-care services while constraining revenue collection as a result of a smaller workforce and a lower savings rate. Although the subregion appears to exhibit adequate fiscal resources now, fiscal risks are rising.

31. In North and Central Asia, the subregional economies faced a marked deterioration in economic growth performance and heightened macroeconomic instability in 2015. In most countries, a deep plunge in global prices of oil, gas and minerals slashed export earnings and fiscal revenues, weakened terms of trade, and resulted in steep currency depreciations and multi-year high inflation. International sanctions and stalled progress to tackle structural weaknesses also drove the recession in the Russian Federation. As the Russian labour market employs numerous migrant workers from neighbouring economies, the recession dampened economic growth in non-oil, remittance-dependent subregional economies.

32. Although some analysts suggest that the economic turmoil may have bottomed out, the outlook is highly uncertain and would depend on oil prices and developments on the geopolitical front. Moreover, risks are clearly tilted to the downside. As a large share of bank credits is foreign-currency denominated, debt burdens and overdue loans have surged owing to exchange-rate depreciations, thereby placing financial stability at risk. A key concern is that oil prices are not expected to pick up soon so the pressure that deterred economic growth in 2015 will persist, with relatively less room for policy response as fiscal positions have weakened because of earlier fiscal stimulus and subpar energy revenue and as monetary policy faces a dilemma amid subdued economic growth, high inflation and risk of further currency depreciation. Poverty has recently increased in the Russian Federation and could rise further amid a prolonged period of economic downturn.

33. The current economic turmoil serves as a stark reminder that the subregion needs to diversify its growth engine beyond resource-based sectors. Although infrastructure connectivity has improved in recent years, reforms to create vibrant business-support services to complement a high value-added manufacturing sector are needed. Economic diversification calls for liberalization in both input and product markets. The policy challenge is to push forward deregulation, such as easing market entry, while having in place strong regulatory bodies that protect consumer interests and ensure fair competition. Questions also remain regarding the desirable size and role of public enterprises in driving future economic growth in these economies where the role of state has historically been dominant.

34. In the Pacific, overall economic growth in 2015 was largely driven by higher production of liquefied natural gas in Papua New Guinea, which accounts for 60 per cent of output in Pacific island developing economies. This masks much slower economic expansions and even contractions in other countries. Economic growth has traditionally been volatile, as economic activity was often driven by movements in global prices of primary commodities, tourism receipts that are highly sensitive to economic conditions in source economies, and one-off developments such as natural

disasters and subsequent reconstruction activities. The near-term growth outlook is set to weaken as capital inflows to the mineral sector in Papua New Guinea have passed their peak levels, while dry conditions brought by the El Niño event would constrain subsistence agriculture.

35. Given their small population size and land area and remote geographical location, Pacific island developing countries are highly exposed to natural hazards and meteorological extremes such as cyclones, tsunamis, droughts and floods. The likelihood that a natural disaster will take place in one of the Pacific island developing countries each year is about one in five, which is greater than any other small states in the world. Because of their magnitude, natural disasters seriously threaten the livelihood of people in the Pacific. For example, damage and losses of Cyclone Pam, which hit Vanuatu in March 2015, are estimated at about 60 per cent of the country's gross domestic output. The impact on the poor is even greater, given that they live in more disaster-prone areas with less protected shelters.

36. As exposure to natural catastrophes is largely determined by geographical conditions, public policies have focused on enhancing a country's ability to cope with natural disasters. In this regard, many countries have recorded larger fiscal buffers, while an insurance scheme linked to natural disasters was launched at the subregional level. Other initiatives are also under way, such as the construction of transport infrastructure resilient to natural disasters, and a national budgeting process that recognizes the cross-cutting nature of natural disasters. Nonetheless, the sheer scale of weather-related extremes calls for closer and perhaps more innovative partnerships between the Pacific islands and the international development community.

37. In South and South-West Asia, the economy of India is gradually gaining growth momentum, underpinned by steady yet uneven progress on policy reforms to attract foreign investment and revive stalled infrastructure projects. However, the positive spillovers of stronger growth in India to other major economies in the subregion are small given limited trade and financial linkages. For the near-term outlook, optimistic prospects assume that structural reforms will move forward at a pace that keeps up with public expectations, thus helping to improve market sentiments. As recent interest-rate reductions have not translated into higher fixed investment, it appears that more reforms to enhance the business environment are needed. The role of policy reforms in supporting future economic growth is particularly important for this subregion because room for countercyclical policies is somewhat limited. However, policymakers will need to remain cognizant of the potential negative implications of such reforms for poor people in general and low-skilled workers in particular.

38. Until recently, the subregion had faced three persistent interconnected macroeconomic imbalances, namely large fiscal deficits, high inflation and wide current-account shortfalls. Lower oil prices resulted in a decline in inflation and have allowed fuel-subsidy rationalization, leading to a positive effect on fiscal positions. Nonetheless, reforms to ease supply-side constraints, such as severe energy shortages and infrastructure deficits, are critical in reducing production costs and promoting export competitiveness. Over the medium term, these reforms would help to relieve cost-push inflation and narrow the current-account shortfalls, thus promoting greater macroeconomic stability in the subregion.

39. Despite a recent pickup, the subregion's economic growth remains below its high potential that is supported by a young population and surplus labour in the agricultural sector. One option to close the output gap is to increase the female workforce participation rate, which is quite low compared to other parts of the world. Policy efforts have been made to overcome core barriers to women's work, such as enhancing availability of and access to high-quality education and providing safe public transport to work in rural areas. Other policies are designed to offset disincentives for women to work, such as offering adequate parental and child-related benefits and taxation frameworks that reduce the net tax liability of working mothers. However, the key question is whether these policies are bold enough to alter deep cultural roots and social norms that discourage or even prohibit the role of women outside the household sector.

40. In South-East Asia, economic growth reached a five-year low in 2015. Merchandise exports declined amid the slowdown in China, but household spending in major economies was also held back by domestic factors such as slower job creation in Indonesia and high household debt levels in Malaysia and Thailand. The near-term growth prospects would benefit from the accommodative monetary policy stances and fiscal stimuli recently launched in larger economies. Countries with lower income levels would continue to enjoy relatively robust economic expansion, thus narrowing the development gaps between frontier economies and emerging economies in the subregion.

41. The ASEAN Economic Community became effective in 2015, with the goal of promoting a single market and production base in the subregion. Lower import tariffs and less restrictive non-tariff barriers should provide a good opportunity for countries such as Cambodia, the Lao People's Democratic Republic and Myanmar to diversify their growth engines, although reforms to enhance the business environment are also needed to attract more foreign direct investment. While foreign investment helps to create more jobs, it may not necessarily benefit government revenue to the expected extent because of various tax exemptions and reductions that are in place. These tax privileges also complicate tax administration and result in lower compliance. Such competition across countries in the subregion and beyond to attract more foreign investment by offering generous tax benefits is not always welfare-enhancing, and should be addressed through stronger regional cooperation on tax matters.

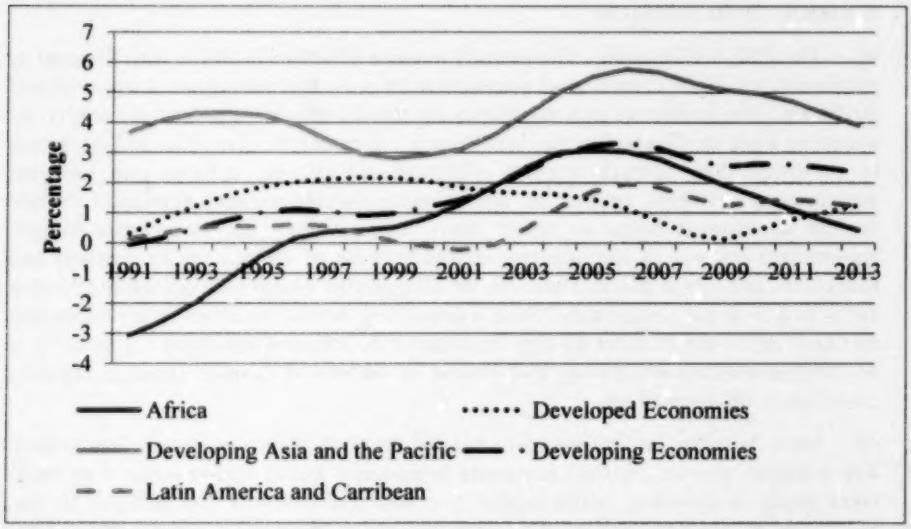
42. More broadly, tax reforms are needed amid changing economic landscapes. For example, greater regional economic integration means that revenue from trade taxes tends to decrease, while capital becomes more mobile and difficult to tax. Moreover, as countries move up the income ladder, there will be more demand for better public social services and urban infrastructure amid a growing middle-class population and rapid urbanization. Critical to a successful tax reform is the need to have more effective coordination among relevant agencies, such as departments within the ministry of finance, foreign investment promotion agency and local governments. Greater use of information technology in tax administration also matters, especially its capacity to help increase tax compliance through risk-based auditing and third-party information-sharing.

IV. The importance of strengthening productivity

A. Analysis of trends in productivity

43. The relatively strong economic growth witnessed in the Asia-Pacific region over the last few decades was primarily driven by factor accumulation; that is, by increases in the labour force and by increases in the capital stock through investment, including from abroad. At the same time, significant increases in productivity, particularly in labour productivity, also took place throughout the region. Indeed, labour productivity growth in developing Asia-Pacific economies has been the highest among developing regions of the world since the 1990s and exceeds that of developed economies by a significant margin. Yet, since the 2008 crisis, it has started to decline (see figure III). Nevertheless, the gap in the level of labour productivity between developing and developed economies has roughly halved, with labour productivity in developed economies being about 12 times higher than that in developing economies in 2013 compared to 24 times higher in 1990.

Figure III
Trend of labour productivity growth by regions



Source: ESCAP calculations, based on data from the ESCAP Online Statistical Database and the World Development Indicators database.

44. While growth rates of total factor productivity in the Asia-Pacific region have also been significantly above those recorded in other regions of the world, they too have declined significantly in the region since the 2008 crisis (see table). One factor that partly explains this slowdown is "labour hoarding" and its impact on efficiency of firms. For instance, during the period from 2007 to 2013, the unemployment rate in several economies of the region remained mostly stable, in comparison with the significant increase that was recorded in developed economies; a higher

employment rate in times of lower demand tends to translate into lower productivity growth.

Table
Average annual growth of total factor productivity across regions

Regions	*1990s*	*2000s*	*2000-2007*	*2008-2014*	*1990-2014*
Developing Asia-Pacific economies	1.41	1.93	2.79	0.96	1.74
Africa	-0.28	0.85	0.28	1.49	0.42
Latin America	0.02	0.07	0.38	-0.29	0.05
Developed economies	0.37	0.32	0.68	-0.09	0.34
Developing economies	1.16	1.64	2.32	0.86	1.46

Source: ESCAP calculations, based on the Penn World Table 8.1, which appears in Robert C. Feenstra, Robert Inklaar and Marcel P. Timmer, "The next generation of the Penn World Table", *American Economic Review*, vol. 105, No. 10 (October 2015). Available from www.rug.nl/research/ggdc/data/pwt/v81/the_next_generation_of_the_penn_world_table.pdf.

45. The declines are worrying as both economic growth and productivity growth play a vital part in development. If unaddressed, these slowdowns will make it more difficult for the region to address its unfinished development agenda, which includes (a) lifting 639 million people, equivalent to two thirds of the global total of extremely poor people, out of poverty, and (b) tackling remaining challenges in the areas of health, education, gender equality, decent employment and access to safe sanitation and drinking water.

46. To bolster economic growth in light of fragile global economic conditions and to make it more inclusive and sustainable, the region should give higher priority to stimulating domestic and regional demand. Fostering domestic demand, however, will require higher levels of productivity and commensurate increases in real wages. Strengthening productivity will also contribute to the success of a number of the Sustainable Development Goals. At the same time, investing in achievement of the Goals will also nurture productivity growth, thereby creating a virtuous cycle between sustainable development, productivity and economic growth.

47. Productivity can be assessed in terms of levels and in terms of growth. It can also be analysed at different levels; for instance, across firms or across sectors, or across the country as a whole. A country that has a higher level of productivity than another one is able to produce more with the same amount of inputs and is thus comparatively more competitive. In contrast, countries with higher productivity growth see larger relative increases in their output than those with lower productivity growth rates. This said, across sectors, industrial/manufacturing productivity tends to grow faster than agricultural productivity due to a variety of factors, including technological change, economies of agglomeration and economies of scale.

48. It is worth noting that as the share of the manufacturing sector in GDP increases, so does aggregate productivity growth, as labour moves from a relatively low productivity sector (such as agriculture) to a higher productivity sector (such as manufacturing). Thus, a rising (or declining) aggregate labour productivity does not necessarily mean that a rising (or declining) contribution is being made by the existing work force in a particular sector. Therefore, rapid growth in aggregate

labour productivity must not be necessarily seen as a positive indicator of development. Rather, the limitations associated with such growth need to be kept in view. For instance, some of the technology imported from developed countries may hold only meagre possibilities of labour absorption as it may suit the labour market conditions of labour-scarce, high-income countries only. With such technology, low levels of labour demand would translate into sluggish employment growth. Thus, the skill bias of modern technology and/or rapid capital accumulation can reduce the pace of absorption of the unskilled labour. This could contribute to stretches of low productivity activities, particularly in the informal sector, by compromising the residual absorption of labour.

49. For instance, agriculture's share in GDP in developing economies of the Asia-Pacific region has declined much faster than the corresponding decline of agriculture in total employment. Specifically, the share of agricultural value added halved between 1990 and 2013, from 19.1 per cent in 1990 to 9.9 per cent in 2013, while the share of agriculture in total employment declined by about 20 percentage points to 36 per cent of the labour force. Large gaps between the two values generally indicate a relatively faster growth of the economy without a corresponding ability to absorb the expanding labour force. Indeed, it could be suggested that a large number of countries in Asia and the Pacific have been unsuccessful in integrating surplus labour into the rest of the economy.

B. Deindustrialization in developing economies

50. Many countries in the region are shifting from an agriculture-based economy to one in which services play a dominant role, leapfrogging the manufacturing stage in their economic transition. Thus, between 1990 and 2013, the share of services in value added increased by a quarter, accounting for more than 53 per cent of total value added, while its share of employment increased by 60 per cent, reaching 37.6 per cent of employment. Moreover, in most developing Asia-Pacific economies, the contribution of the service sector to labour productivity growth was the most important one. The contribution of industry exceeded that of services in Azerbaijan and China only.

51. This shift to services is coming at a too early level of development in many countries in the region and may not be conducive to fostering development. One reason could be that services are not as tradable as manufactured goods; also, services do not usually exhibit the same technological dynamism, which therefore makes them a poor substitute for export-oriented industrialization. Therefore, it is imperative to reindustrialize and to stimulate productivity growth.

52. While countries that have developed successfully, such as the Republic of Korea, have generally done so on the back of rapid industrialization, it is worrying that many developing economies in the region are already deindustrializing. Indeed, when services contributed to half of value added output in developed economies, their levels of income per capita were on average five times higher, in real terms, than is currently the case in developing economies in the region. Moreover, transforming towards a service-based economy may further increase downward pressure on productivity growth in the future since productivity in the service sector is usually lower than that in the industrial sector.

53. Increasing productivity in agriculture and industrializing the rural sector is thus particularly important. With almost four out of ten workers still engaged in agriculture and 55 per cent of the developing region's population living in rural areas, the role of agriculture is vital to strengthening domestic demand. In addition, agriculture is important as the sector provides an important basis for many other activities, including manufacturing. For instance, in several economies, including Pakistan, Indonesia, the Philippines and Viet Nam, food, beverages and tobacco contribute between 20 per cent and 30 per cent of total value added in manufacturing. In Nepal, the contribution is more than a third of total value added in manufacturing and in Fiji it reaches almost a half. Greater labour productivity in agriculture would thus enable higher incomes in the rural sector, which would contribute to strengthening domestic demand and to reindustrializing economies.

C. The nexus between productivity and the Sustainable Development Goals

54. The Sustainable Development Goals provide an entry point to strengthen productivity. At the same time, focusing on productivity provides an overarching framework for countries to tackle the achievement of several Goals, thereby creating a virtuous cycle between the Goals and productivity. It must be recognized, though, that at an early stage of development productivity-driven growth may not be consistent with decent jobs and higher wages.

55. Raising agricultural productivity must be at the centre of focus to end poverty (Goal 1) and end hunger and achieve food security (Goal 2). Increasing productivity, especially in the agriculture sector, contributes to the reduction of poverty directly by positively affecting rural households' income obtained from agricultural and non-agricultural activities. Estimates show that increasing agricultural productivity relatively modestly over the period 2016 to 2030 could lift an additional 110 million people out of poverty in developing countries in the region. Agricultural productivity growth also reduces food insecurity of poor households as household incomes tend to be positively correlated with output per worker in agriculture. Greater agricultural productivity would further contribute to lower food prices, thereby increasing food security and leading to an increase in real consumption, which would be particularly beneficial to poor households.

56. Efforts to eradicate poverty, particularly in the rural sector, and attain Goal 1, as well as to achieve higher levels of productivity in agriculture and ensure the associated higher incomes in the rural sector, would foster development of the rural sector and encourage industrialization (Goal 9). As higher levels of productivity in agriculture will free up labour from that sector, which will be available to work in the non-agricultural sector, it will be important to consider a broader development strategy. A focus on accommodating the agricultural push of labour will provide an opportunity for moving towards full and productive employment and decent work for all to achieve a sustainable and inclusive economic growth (Goal 8). In particular, by encouraging a structural change following an agriculture-industry-service sequence, rural industrialization through small-scale industries could be achieved. Firms in the industrial and service sectors would also be able to benefit from the additional demand resulting from the decreasing number of poor people, and from higher rural incomes.

57. Absorbing the agricultural push of labour will also require additional training, particularly of those with low skills, especially in view of the skill bias in modern technology, which reduces the scope for absorption of unskilled surplus labour. Therefore, mechanisms are needed to ensure that populations have access to quality education and lifelong learning (Goal 4), particularly if full and productive employment is to be provided. Moreover, education needs to be reformed for workers' skills to become and remain relevant to an industrializing framework. This requires emphasizing the lifelong availability of quality education for innovation and productivity.

58. Combating climate change and its impacts (Goal 13) can also have a beneficial impact on productivity growth, especially productivity in the agricultural sector. It is worth highlighting that boosting productivity is generally seen as a predominantly economic concern. Typically, little attention is paid to the efficiency of the economic system in terms of intensity of resource use, particularly energy, and the associated environmental degradation. The current dominant development strategy tends to favour a "grow now, clean up later" approach without assessing the significant socioeconomic and environmental costs; costs most often borne by the most vulnerable in society. The climate change resulting from this approach is negatively affecting productivity growth, indicating the need for a change in development strategy.

D. Policies to increase productivity

59. Given the declining trend in productivity growth and its relationship with the Sustainable Development Goals, countries in the region would benefit from focusing on policies that foster productivity growth and share productivity gains. This would facilitate the pursuit of the Goals as well as improving economic growth prospects. Moreover, by accelerating productivity growth that is supported by increases in real wages, countries may be able to catalyse a shift to a growth model in which domestic and regional factors play a relatively larger role in driving demand. Thus, by focusing on policies that increase productivity, economies can increase the aggregate supply as well as the aggregate demand, while enhancing their societies' well-being.

60. Fostering agricultural productivity and industrializing the rural sector will be key to strengthening domestic demand, and must be at the centre of the effort deployed by Governments. In addition to stimulating economic growth, this will contribute to equity and political stability. Ways to strengthen the role of the rural sector and increase agricultural productivity include diversifying into high-value crops, focusing on quality and standards, developing rural infrastructure such as roads, irrigation and information and communications technology, and strengthening investment in research and development.

61. Although the reallocation of labour and capital across sectors did not play a significant role in labour productivity growth, the issue of large surplus labour in agriculture cannot be solved within the boundaries of agriculture alone. Appropriate strategies and policies are therefore needed that help absorb the push of labour from the agricultural sector and that enable accelerating productivity growth. These policies include developing the non-farm sector by fostering rural industrialization through small-scale industries. This can strengthen linkages between agricultural

and non-agricultural sectors and lead to backward-forward and production-consumption linkages within agriculture and between the agricultural and non-agricultural sectors.

62. Importantly, Governments' policies should facilitate such movements by retraining workers to make them more employable (for example, by training farmers to operate machines, and training industrial workers to improve technical services in rural areas) and offering productivity-based financial incentives for encouraging such movements (by linking gains in productivity more closely to wages, for instance).

63. Strengthening research and development is important to strengthen skills in the labour force. Although expenditure allocated to research and development in the developing region has doubled since the end of the 1990s to 1.4 per cent of GDP, it lags behind developed regions by a wide margin. Another avenue is to expand undergraduate and technical education and strengthen vocational schools. Indeed, the contrast between, on the one hand, the relatively weak rankings of some of the region's economies in the Organization for Economic Cooperation and Development Programme for International Student Assessment* and, on the other, the fact that the developing economies with the highest labour productivity in the region (Singapore; Hong Kong, China; and the Republic of Korea) also rank highest in the Programme highlights the importance of education in providing the skills required to apply current technologies as well as to assimilate, adapt and develop new technologies.

64. Concerning the need to raise productivity in the industrial sector, there needs to be a trade-off between the provision of fiscal incentives and the need to raise more fiscal revenues to strengthen development. Nevertheless, encouraging firms to innovate and conduct research and development activities through fiscal incentives and financial benefits aimed at making industry (in particular, manufacturing) more productive could lead to more efficient, technologically up-to-date, and competitive production. Programmes to upgrade the skills of the workforce, infrastructure-related programmes that refer not only to physical but also to financial and social infrastructure, and efforts to improve accessibility of enterprises to information and communications technology are among the initiatives that could increase the productivity of industry while also spurring spillover effects related to foreign direct investment.

65. Lastly, increases in labour productivity will have to be passed on to workers. To ensure that economies in the region are able to shift to a development model in which domestic and regional demand play a greater role, the decline in the share of labour income in total output needs to be reversed. This will require the linking of gains in labour productivity more closely to commensurate gains in wage levels. To so do, Governments can strengthen the enabling environment for collective bargaining in the region. Minimum wages can also act as an important policy tool to ensure that wage levels are increased. Social protection measures (including unemployment insurance and pensions) would foster domestic demand further, and enable a smoother reallocation of workers between sectors.

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* The Programme for International Student Assessment aims to assess quality, equity and efficiency of school systems so as to evaluate the ability of education systems to provide young people with key knowledge and skills that are essential for full participation in modern societies.